

ATTACHMENT 1

**Before the
Federal Communications Commission
Washington, D.C. 20554**

In the Matter of)	
)	
Special Access Rates for Price Cap Local)	WC Docket No. 05-25
Exchange Carriers)	
)	
AT&T Corp. Petition for Rulemaking to)	
Reform Regulation of Incumbent Local)	RM-10593
Exchange Carrier Rates for Interstate)	
Special Access Services)	

**COMMENTS OF
THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE**

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June 13, 2005

SUMMARY

The Ad Hoc Telecommunications Users Committee submits these Comments pursuant to the Commission's January 31, 2005 Order and Notice of Proposed Rulemaking ("*NPRM*") in the dockets captioned above.

The Commission's failure to revise its special access rules to reflect the incumbent local exchange carriers' ("ILECs' ") virtual monopoly over special access services has allowed the ILECs to overcharge with impunity for the past eight years. During that period, the ILECs' prices and profits have soared well beyond any level that the ILECs can explain away with the tired refrain that their high earnings are merely a reporting anomaly caused by the vagaries of regulatory accounting rules. The Commission's inaction as the ILECs have steadily increased their rates and their earnings has also become a significant obstacle to the development of robust competition in telecommunications markets due to the critical role that special access plays as a bottleneck facility for both local and interstate traffic. Indeed, the ILECs' ability to raise special access prices and earn supra-competitive profits without attracting competitive entry by alternative providers of special access calls into question many of the fundamental economic assumptions underlying the Commission's de-regulatory policies over the past several years.

As substantial, geographically-diverse end users of telecommunications services nationwide, Ad Hoc members are uniquely qualified to provide a credible, unbiased, and informed perspective on the state of competition in the telecommunications marketplace. The members of Ad Hoc are among the

nation's largest and most sophisticated corporate buyers of telecommunications services, including interstate special access services; fourteen of Ad Hoc's members are "Fortune 500" companies, including ten of the "Fortune 100." Committee members come from a broad range of industry sectors (including manufacturing, financial services, insurance, retail, package delivery, and information technology) and maintain tens of thousands of corporate premises in every region of the country. They estimate their combined annual spend on communications services at between two and three billion dollars per year.

In these comments, Ad Hoc urges the Commission to abandon its "pricing flexibility" experiment. As described in more detail herein and in the attached White Paper "*Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Uncertain Markets*" competition for ILEC special access services has not developed in the manner "predicted" by the Commission at the time the pricing flexibility rules were adopted, and end users of special access services are left with no protection from the ILECs' excessive pricing practices.

Once granted Phase II pricing flexibility, the ILECs have used the "Pricing Flexibility" rules to exploit end users in markets and at locations where no competitive alternatives exist. Special access prices in MSAs in which Phase II pricing flexibility has been granted have implemented pricing increases that have been both substantial and sustained. Users of special access services in those putatively competitive MSA have been forced to pay prices that are substantially higher than the prices charged to customers in MSAs that have not met the Commission's Phase II triggers – customers that are still protected under the

Commission's price caps plan. Widening the gap between the prices available in Phase II pricing flexibility MSAs, and those still subject to Commission price regulations, the ILECs held prices for Phase II services while the prices outside of those MSAs were reduced through annual price caps rate adjustments.

Ad Hoc also submits to the Commission that, in addition to reviewing the specific price levels found in Phase II MSAs, it examine the accounting rates of return being earned on interstate special access services. The average rate of return for the special access category for the four RBOCs was 53.7% for 2004. The 53.7% return level represents the latest in a series of year after year increasing special access earnings levels – up from 43.7% in 2004. Clearly, neither existing competition, nor the threat of potential competition is working to constrain the ILECs market power.

The Ad Hoc Committee urges the FCC to reinstate incentive regulation for all special access services unless and until competition develops in special access markets. Specifically Ad Hoc proposes that the Commission do the following:

- Re-initialize the rates for all special access services (including those presently subject to Phase II pricing flexibility) at levels that produce an 11.25 Rate of Return
- Apply new and improved price caps rules to all special access services. The price cap plan should include:
 - a productivity or “X” factor developed specifically for the interstate special access basket;

- a “g” factor with all of the benefits of growth flowing to purchasers of access services rather than ILECs;
- earnings sharing; and
- a more granular basket, band and service category structure.
- Replace the existing pricing flexibility rules with a new self-executing downward-only pricing flexibility plan, that would relieve the Commission of constantly struggling to evaluate and predict competitive conditions, protect ratepayers from pricing increases in areas where competition is not sufficient to discipline pricing, and afford the ILECs the opportunity to lower prices as competitive conditions warrant.

Finally, AdHoc urges the FCC to adopt a plan of interim relief effective with the pending July 1 annual access tariff filings. Specifically, Ad Hoc requests that the Commission implement a 6.5% X-Factor as a “transitional mechanism to lower rates” for all special access services, bringing all non-contract tariff based prices for services presently subject to Phase II pricing flexibility back to the levels they would have been at had they been subjected to price caps-based reductions all along.

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INTRODUCTION

The Commission's failure to revise its special access rules to reflect the incumbent local exchange carriers' ("ILECs' ") virtual monopoly over special access services has allowed the ILECs to overcharge with impunity for the past

¹ *Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25, *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593, Order and Notice of Proposed Rulemaking, FCC 05-18 (rel. January 31, 2005) ("*Notice*" or "*NPRM*").

eight years. During that period, the ILECs' prices and profits have soared well beyond any level that the ILECs can explain away with the tired refrain that their high earnings are merely a reporting anomaly caused by the vagaries of regulatory accounting rules. The Commission's inaction as the ILECs have steadily increased their rates and their earnings has also become a significant obstacle to the development of robust competition in telecommunications markets due to the critical role that special access plays as a bottleneck facility for both local and interstate traffic. Indeed, the ILECs' ability to raise special access prices and earn supra-competitive profits without attracting competitive entry by alternative providers of special access calls into question many of the fundamental economic assumptions underlying the Commission's de-regulatory policies over the past several years.

As substantial, geographically-diverse end users of telecommunications services nationwide, Ad Hoc members are uniquely qualified to provide a credible, unbiased, and informed perspective on the state of competition in the telecommunications marketplace. The members of Ad Hoc are among the nation's largest and most sophisticated corporate buyers of telecommunications services, including interstate special access services; fourteen of Ad Hoc's members are "Fortune 500" companies, including ten of the "Fortune 100." Committee members come from a broad range of industry sectors (including manufacturing, financial services, insurance, retail, package delivery, and information technology) and maintain tens of thousands of corporate premises in every region of the country. They estimate their combined annual spend on

communications services at between two and three billion dollars per year.

Because Ad Hoc admits no carriers as members and accepts no carrier funding, Ad Hoc has no commercial self-interest in the imposition of unnecessary regulatory constraints on incumbent service providers. Indeed, as high-volume purchasers of telecommunications services, Ad Hoc members have historically been among the first beneficiaries of the FCC's de-regulatory efforts. As a consequence, Ad Hoc has consistently advocated de-regulation for telecommunications services as soon as a service market becomes competitive.

But the special access market is not yet sufficiently competitive for market forces to discipline prices and stimulate demand-responsive service quality and innovation. Accordingly, the FCC must not abdicate its responsibility to protect end-users from the supracompetitive prices and sluggish carrier performance that have resulted under the current regulatory regime for special access. The Commission must instead adapt its regulatory regime to the competitive realities of local and long distance markets and protect the interests of consumers and competition until such time as competitive providers of special access services emerge.

The Commission based its current regime of pricing flexibility upon a leap of faith – that competition was about to flower in local access markets thanks to the market-opening requirements of the 1996 amendments to the Communications Act and the Commission's rules implementing those amendments. Instead of revising its regulations once access markets actually became competitive, however, the Commission assumed that competition would

inevitably flourish once a competitive LEC (“CLEC”) took certain steps to enter a market. Based on this “predictive judgment,” the Commission’s pricing flexibility rules eliminated price caps protection for customers of ILECs once the ILEC demonstrated that CLECs had taken the requisite steps to enter their markets.

The Commission’s predictions regarding the emergence of competition in access markets proved to be wrong, and its standards for ascertaining “irreversible market entry” by competitors proved to be misguided. Indeed, the lack of competition for special access, and the Commission’s continuing failure to regulate this non-competitive market effectively, already costs enterprise customers over \$17.5 million dollars *per day* in excessive charges for the special access services they buy.²

Accordingly, as discussed in greater detail in the sections below, Ad Hoc urges the Commission to take the following steps to protect customers from the ILECs’ exploitive special access prices and to establish market conditions conducive to the development of competition:

- Re-initialize special access rates, including both “pricing flexibility” rates and rates in areas still subject to price caps, at levels that would produce earnings at the Commission’s authorized level of 11.25%.
- Apply price caps rules to the ILECs’ special access services, with an

² Attachment A, “*Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Uncertain Markets*,” Economics and Technology, Inc. (August 2004) (“*ETI White Paper*”), as amended by Attachment B, Declaration of Susan M. Gately (June 13, 2005) (“*Gately Declaration*”) at page 5. Attachment A was also filed as an *ex parte* presentation in *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593. See Letter from Colleen Boothby, Counsel for the Ad Hoc Telecommunications Users Committee, to Marlene H. Dortch, Sec’y, Federal Communications Commission, Att. (filed Aug. 26, 2004).

updated productivity offset and provisions for sharing ILEC earnings that exceed a specified reasonable level.

- Grant price caps ILECs unlimited downward pricing flexibility to respond to competition. Services priced using this unlimited downward pricing flexibility would be removed from price caps baskets.
- As an interim form of relief pending adoption of final rules in this docket, require ILECs in their July 1, 2005 annual access filing to restore special access prices to the levels that would be in place in accordance with the CALLS settlement had the Commission not adopted the pricing flexibility rules.

I. THE COMMISSION MUST ABANDON ITS “PRICING FLEXIBILITY” EXPERIMENT UNTIL COMPETITION DEVELOPS TO PROTECT END USERS FROM THE ILECS’ PRICING PRACTICES

In this proceeding, the Commission is examining “whether the Commission’s pricing flexibility rules have worked as intended and, if not, whether they should be modified or repealed.”³ The experience of enterprise customers, and the ILECs’ astronomical prices for – and profits from – their special access services, demonstrate that repeal of the pricing flexibility rules is long overdue.

ILEC special access plays a crucial competitive role in the telecom marketplace because it is, in most cases, the only “final mile” link between large business customers and their carriers, including both interexchange carriers (“IXCs”) and CLECs. In addition, the high-capacity transmission services offered by ILECs as special access services are the building blocks for enterprise customers’ dedicated or “private line” voice and data networks. Large

³ *NPRM* at para. 71.

commercial enterprises like Ad Hoc's members rely heavily on these private corporate networks, specialized data systems, and high-capacity, mission-critical transmission facilities connecting locations with heavy traffic volumes. As a result, the ILECs' special access rates drive both the wholesale and retail prices that enterprise customers must pay to deploy nation-wide data and voice networks.

Enterprise customers who purchase special access – both directly, as customers of the BOCs, and indirectly, as customers of IXC and CLECs who must, in turn, purchase BOC special access to reach their customers' premises – ultimately pay the price if special access rates are not subject to competitive pressure. The lack of competition in the bottleneck special access market thus creates a two-fold problem – it can be exploited by the ILECs to impede competitive entry into their telecommunications markets and it allows the ILECs to extract supra-competitive prices from enterprise customers absent appropriate regulation by the Commission.

A. The ILECs Have Used the "Pricing Flexibility" Rules to Exploit End Users in Non-Competitive Markets

The Bell Operating Companies ("BOCs") have repeatedly claimed before this Commission that the special access market is fully competitive. But they have not supported their claims with factual evidence, relying instead on what Ad Hoc has characterized as "compelling rhetoric, comforting economic theories, and sunny speculation" regarding the market-opening potential of new and

innovative technologies that have yet to be fully deployed.⁴ Customers do not live in a theoretical world, however. In the real-world marketplace where enterprise customers search for competitively-priced telecom services, rhetoric and speculation are no substitute for actual competitive alternatives. The marketplace experience of enterprise customers like the members of Ad Hoc is entirely inconsistent with the rosy competitive picture painted by the BOCs for the past several years in their filings with this Commission. As a result, Ad Hoc has repeatedly, and with increasing urgency, alerted the Commission to the lack of competition in the special access marketplace and filed supporting factual evidence and economic analyses in a variety of policy and rulemaking proceedings.⁵ Ad Hoc urged the FCC to re-establish incentive regulation for the

⁴ Comments of Ad Hoc Telecommunications Users Committee (May 10, 2005), *SBC Communications Inc. and AT&T Corp., Applications for Approval of Transfer of Control*, WC Docket No. 05-65.

⁵ See, e.g., Comments of Ad Hoc Telecommunications Users Committee (Jan. 22, 2002) at 2-3, *Performance Measurements and Standards for Interstate Special Access Services*, CC Docket Nos. 01-321, 00-51, 98-147, 96-98, 98-141, 96-149, 00-229, Notice of Proposed Rulemaking, 16 FCC Rcd 20896 (2001) ("Special Access Performance Standards Rulemaking"); Comments of Ad Hoc Telecommunications Users Committee (Mar. 1, 2002) at 14-17, *Review of Regulatory Requirements for Incumbent LEC Broadband Services; SBC Petition for Expedited Ruling That It Is Non-Dominant in its Provision of Advanced Services and for Forbearance From Dominant Carrier Regulation of These Services*, CC Docket No. 01-337, Notice of Proposed Rulemaking, 16 FCC Rcd 22745 (2001) ("Broadband Regulation Rulemaking"); Reply Comments of Ad Hoc Telecommunications Users Committee (Jul. 1, 2002) at i, *Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*, CC Docket Nos. 02-33, 95-20, and 98-10, Notice of Proposed Rulemaking, 17 FCC Rcd 3019 (2002) ("Broadband Wireline Internet Access Rulemaking"); Comments of Ad Hoc Telecommunications Users Committee (Dec. 2, 2002) at 5, *AT&T Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM No. 10593, 17 FCC Rcd 21530 (2002) ("AT&T Special Access Petition"); Comments of Ad Hoc Telecommunications Users Committee (Jun. 30, 2003) at 6, *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, and *2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules*, CC Docket No. 00-175, Further Notice of Proposed Rulemaking, 18 FCC Rcd 10914 (2003) ("ILEC Broadband Dom/Non-Dom Rulemaking").

ILECs' special access services in order to protect customers from the ILECs' exploitation of their market power through excessive rates and commercially unreasonable terms and conditions.⁶

In its pleadings, Ad Hoc described the actual market experience of its members and the absence of competitive alternatives in the geographic markets where members sought to obtain special access services, despite members' active efforts to seek out competitive choices. Ad Hoc identified a number of factors that stand in the way of effective competition in the local exchange and exchange access markets:

- The pricing flexibility rules have resulted in price *increases* for special access services, despite record earnings by the ILECs, a result that is fundamentally inconsistent with the outcome of a market with effective competition.
- Ad Hoc's members – whose high-volume purchases make them the first customers new entrants would seek out – have in fact experienced few competitive alternatives for their exchange and exchange access service requirements.
- Intermodal competition via cable modem service is not a factor for large business users due to the limited deployment of cable infrastructure in business areas and the severe security and reliability concerns raised by cable-based services and technologies.
- Meanwhile, the capital markets for competitive LECs ("CLECs") as a whole have crumbled over the past few years, driving many CLECs out of the market or into bankruptcy and placing severe restrictions on the ability of the few remaining CLECs to stay in the market, let alone expand their service capabilities.
- By contrast, the financially secure ILECs have refrained from aggressively pursuing out-of-region local markets, notwithstanding the specific

⁶ *Id.*

“commitments” by both SBC and Verizon to do so in exchange for FCC approval of their respective merger applications.⁷

Ad Hoc members also became increasingly concerned over the past few years by the mismatch between their marketplace experience and the BOCs’ representations in regulatory and public policy proceedings that local markets are sufficiently competitive to be de-regulated even more. As Ad Hoc reported in its comments in the *Broadband Regulation Rulemaking*,⁸ its members could find no competitive alternatives to ILEC services to meet their broadband business services requirements in the overwhelming majority of their service locations.⁹ Yet the BOCs maintained before the Commission that they were losing ground rapidly to fierce competition in local markets, in response to which the Commission sought public comment on a variety of de-regulatory initiatives.¹⁰

To determine whether Ad Hoc members were somehow insulated from these allegedly pervasive competitive pressures, despite the numerous and diverse geographic locations and industry sectors represented in Ad Hoc’s

⁷ See, e.g., *Applications of Ameritech Corp., Transferor, and SBC Communications Inc., Transferee, For Consent to Transfer Control of Corporation Holding Commission Licenses and Lines Pursuant to Sections 214 and 310(d) of the Communications Act and Parts 5, 22, 24, 25, 63, 90, 95 and 101 of the Commission’s Rules*, CC Docket 98-141, Memorandum Opinion and Order, 14 FCC Rcd 14712 (1999).

⁸ Comments of Ad Hoc Telecommunications Users Committee (Mar. 1, 2002) in *Broadband Regulation Rulemaking*.

⁹ For locations with capacity requirements totaling four DS-1 circuits or below, members reported that viable competitive alternatives to the ILEC were available at less than 10% of their locations. See Comments of Ad Hoc Telecommunications Users Committee (Mar. 1, 2002) in *Broadband Regulation Rulemaking* at 14-17.

¹⁰ See *Broadband Regulation Rulemaking*, *Broadband Wireline Internet Access Rulemaking*, and *ILEC Broadband Dom/Non-Dom Rulemaking*, *supra*, note 5.

membership, Ad Hoc directed its economic consultants to analyze the access services market and the available data for signs of competitive market forces. The results of that analysis are contained in Attachment A to this pleading and described in greater detail below. Unfortunately, Ad Hoc's economic analysis confirmed the individual experiences reported by its members – access markets, and the special access market in particular, are simply not competitive. The ILECs' record-setting prices and profits for special access demonstrate that they face little or no competition to protect consumers from exploitive rates and practices.

Attachment A is a white paper released in August, 2004 by the Ad Hoc Committee's economic consultants, Economics and Technology, Inc. ("ETI"). The paper, *Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Uncertain Markets ("ETI White Paper")*,¹¹ demonstrates that competitive alternatives simply do not exist for the "last-mile" telecommunications services enterprise customers must have to conduct business. Attachment B is a declaration by Susan M. Gately, Senior Vice President of ETI, containing updated data for the *ETI White Paper* where such data exist ("Gately Declaration").

The dearth of competitive alternatives for enterprise customers appears to have surprised some telecommunications policy makers. Many policy makers understandably assume that the largest corporations – companies that annually

¹¹ See note 2, *supra*.

spend tens and even hundreds of millions of dollars on local and long distance, voice and data telecom services – are the primary beneficiaries of competition in all telecom sectors. As the *ETI White Paper* documented, however, enterprise customers have no access options in most locations other than the services and facilities available from ILECs. Moreover, the ILECs have not hesitated to exploit this market dominance by consistently imposing higher prices for last mile services in precisely those geographic and product markets where the Commission has granted regulatory flexibility. ILECs confront so little competition in the special access market that they are able in some cases to earn annual returns in excess of 50% on each dollar of special access investment.

In Chapter 2 of the *ETI White Paper*, entitled *No Way Out: The Lack of Alternatives to Special Access*, ETI documented that although there is intense competition for *interexchange* services (including both switched voice and dedicated voice and data), the ILEC monopoly persists largely unchallenged in the case of switched and dedicated *access* connections between interexchange carrier networks and individual end-user sites. Contrary to the common misperceptions regarding large users' telecommunications needs, enterprise customer locations are not confined primarily to the large buildings and commercial centers where competing service providers are most likely to target their initial market entry. Instead, corporate networks frequently involve tens of thousands of small sites – the vast majority of which are in places where the ILEC remains the only source of connectivity.

The *ETI White Paper* relied on evidence supplied by the carriers themselves to corroborate the market experience reported by Ad Hoc members. For example, in a declaration accompanying its 2002 Petition for the instant rulemaking,¹² AT&T reported that it had been unable to obtain non-ILEC special access services for all but a small fraction of its special access requirements. Specifically, AT&T stated that it serves some 186,000 buildings using special access facilities and services. But it must still rely upon the ILECs' special access services for all but 5% of those cases (9,700 buildings).¹³ Of the 5% of buildings for which AT&T has been able to obtain access from an alternative provider, the majority are self-provided circuits, and only about 3,700 buildings – or 2% of the total – are served using other CLECs' facilities.¹⁴ As a CLEC, AT&T has facilities to only 6,000 of the roughly 3-million commercial buildings in the U.S. – a mere one-fifth of one percent.

Sprint Corporation has provided similar evidence, which is discussed in some detail in the *ETI White Paper*.¹⁵ Sprint's most recent estimates of the number of commercial buildings and the number of alternative access provider connections into those buildings are both larger than AT&T's,¹⁶ but, like AT&T's

¹² *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593 (filed Oct. 15, 2002) ("*AT&T Special Access Petition*"). The *NPRM* incorporated into the instant docket the record compiled in RM-10593.

¹³ *AT&T Special Access Petition*, Declaration of Kenneth Thomas at 1.

¹⁴ *Id.* at 1.

¹⁵ *ETI White Paper* at 17-18.

¹⁶ Sprint estimates the total number of US commercial buildings at just under 750, 000, and estimates that there are approximately 30,000 connected buildings. *AT&T Special Access*

data, Sprint's results in a CLEC connectivity rate of less than 5% for the commercial buildings in the U.S. Moreover, Sprint goes on to report that in 12,000 of the buildings with alternative access provider connections (*i.e.*, for 40% of the buildings), the connection is limited to a single customer and the CLEC is unable to provide access to other customers located in the same building.¹⁷

Similar (and more recent) evidence has come from the BOCs' filings in the course of the Commission's review of its *Triennial Review Order* ("TRO").¹⁸ The BOC evidence reveals that in the vast majority of cases, CLECs must use BOC-provided special access services to reach their customers. The *ETI White Paper* discusses this evidence in Chapter 2, which contains reproductions of two maps prepared and submitted by Verizon in the TRO docket. The maps document that even in what many consider to be the most competitive local service markets in the country (namely, the New York and Washington metropolitan areas served by Verizon), CLECs must rely upon BOC special access loops to reach enterprise customers.¹⁹ Similar filings were made by SBC, BellSouth, and Qwest showing exactly the same patterns.²⁰ Excerpts from the carriers' filings can be

Petition, Comments of Sprint Corporation, filed Dec. 2, 2002 ("*RM 10593 Sprint Comments*"), at 4.

¹⁷ *Id.* at 4.

¹⁸ *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 04-313, 01-338, 96-98, 98-147, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978 (2003) ("*TRO Remand Proceeding*") (subsequent history omitted).

¹⁹ *ETI White Paper*, at 13-15.

²⁰ *See* Gately Declaration at fns. 15-17.

found in the *ETI White Paper* and are discussed in the Gately declaration.²¹

The paper also documents the results of a survey of Ad Hoc Committee members undertaken in 2002 which revealed that, for locations requiring four or fewer DS1 circuits, competitive alternatives to BOC special access were available at Ad Hoc member locations less than 10% of the time.²²

The paper's bottom line, as updated by the Gately Declaration, is inescapable. Using the most optimistic claims provided by the carriers of the number of buildings where competitive access service is available, the ILECs nevertheless remain the sole source of special access connectivity at roughly 98% of business premises nationwide, even for the largest corporate users. Figure 1 below illustrates this situation.

²¹ *Id.* at 13-16.

²² *ETI White Paper*, at 19-20.

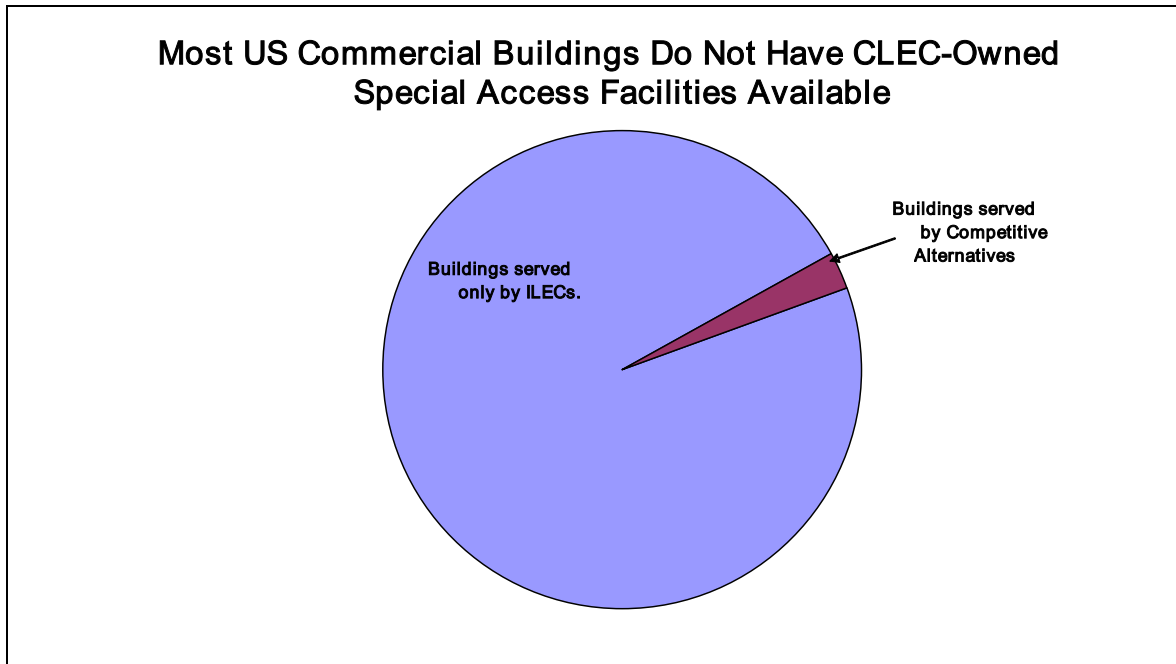


Figure 1

The *ETI White Paper* notes that the lack of competitive alternatives for high capacity access services is attributable to a variety of well-recognized barriers to competitive entry, especially the very high fixed costs and risk associated with such investments.²³ These conditions are not likely to change any time soon, for reasons described in detail in the paper.²⁴

The *ETI White Paper* also examined the marketplace conduct of the dominant ILECs, which revealed a pattern of significantly higher prices in precisely those geographic areas in which the Commission has given the BOCs pricing flexibility because of the presumption in the pricing flexibility rules that competition will materialize. The pricing pattern thus confirms the absence of

²³ *ETI White Paper* at 24-26.

²⁴ *Id.*

actual competition in those areas. In the chapter entitled *Undisciplined Pricing and Limitless Earnings in the Face of Only Putative Competition*, the *ETI White Paper* points out that the BOC's pricing behavior confirms the numerical evidence, discussed above, of the lack of competitive alternatives.

B. Special Access Price Increases Under the Pricing Flexibility Rules Have Been Substantial and Sustained

If users confronted actual competitive choices for BOC switched and special access services, or if the BOCs believed that such competitive alternatives could materialize, they would be lowering their prices in purportedly competitive markets, and their earnings would be moving down toward competitive levels. But that is not happening. ETI's pricing review for the *ETI White Paper* revealed that, in the markets where the FCC's pricing flexibility "triggers" have been satisfied, ILEC prices are higher than those in regulated "monopoly" areas, while ILEC profits (as reflected in realized rates of return) for special access services have risen to astronomical heights.

At the time that the *ETI White Paper* was released, the most recent BOC statistics (year-end 2003) revealed average earnings across the BOCs in the special access category of a jaw-dropping 43.7%.²⁵ Figure 2, below, taken from the Gately Declaration attached to this pleading,²⁶ documents that the average special access return has now increased to an awe-inspiring 53.7%, with earnings for the individual BOCs ranging from 31.6% for Verizon to 81.9% for

²⁵ *ETI White Paper* at 28.

²⁶ See Gately Declaration, updated figure 3.1.

BellSouth.

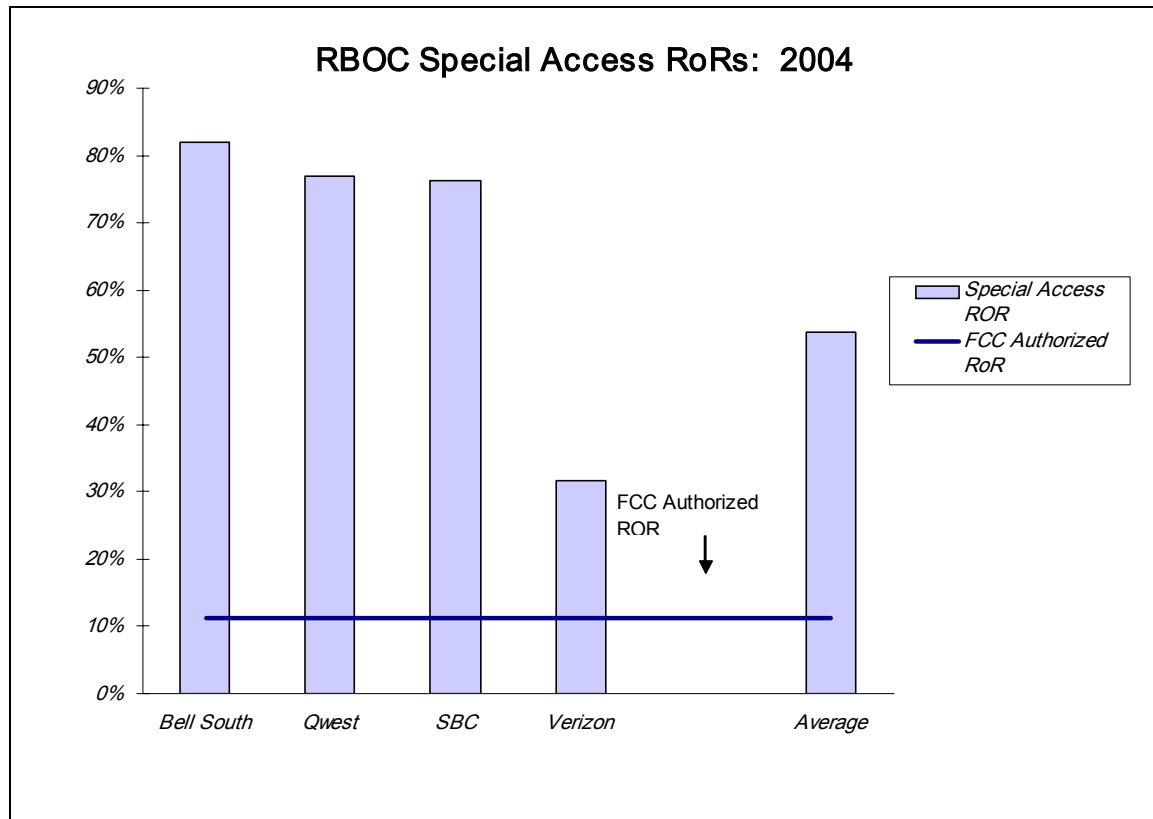


Figure 2

1) Most Prices In Phase II Pricing Flexibility MSAs Are Substantially Higher Than Those In Price Caps Regulated Areas.

In order to assess the state of competition in areas that have qualified for pricing flexibility, the NPRM asked interested parties to “provide more recent data that demonstrate whether or not substantial and sustained special access price increases have occurred in Phase II MSAs.”²⁷ Ad Hoc provides such evidence below which demonstrates that the price increases that have occurred are substantial and have been sustained.

²⁷

NPRM at 74.

An analysis of special access prices reveals that all four BOCs have increased prices for DS-1 circuits, DS-3 circuits or both in *every* region for which they have received pricing flexibility.²⁸ For example, since receiving pricing flexibility in Washington state in 2001, Qwest has increased the prices for services in Phase II MSAs three separate times, resulting in a cumulative increase of 56% in the price of a 10-mile DS-3 circuit purchased on a month to month basis.²⁹ Qwest has similarly increased the price of a DS-1 circuit by 25%.³⁰ The first Qwest increase occurred fully three and half years ago, on November 1, 2001³¹, and has been not only *sustained* but expanded with additional increases that occurred in February and August 2004.³² At the same time that Qwest was implementing unprecedented price increases in the MSAs for which it had been granted pricing flexibility, Qwest was reducing prices in areas still regulated under the FCC's price caps plan. The difference that exists today between Qwest's price caps and pricing flexibility rates for a 10-mile DS3 circuit is close to 70%. A customer requiring such a circuit in a Qwest price caps regulated MSA today would be billed \$3,520 per month. A customer requiring an

²⁸ Special access service rates are calculated as 10 mile circuits, and are calculated both for month-to-month service pricing, and term discount pricing for a 3-year term. Price increases are measured as the change in the service rate between May 2001 and June 2005. Ad Hoc has not reviewed and is not providing evidence relative to the pricing for higher bandwidth services.

²⁹ Qwest Corporation, FCC Tariff No. 1, Access Service, Section 17.2.12, Effective August 31, 2004, ("*Qwest Access Tariff*").

³⁰ *Id.*

³¹ See Qwest FCC Transmittal 145, effective November 1, 2001.

³² See Qwest FCC Transmittals 186, effective February 28, 2004 and Transmittal 206, effective August 31, 2004. See also generally Petitions to Reject, Suspend and / or Investigate Transmittal 206 filed by AT&T, MCI and Time Warner Communications filed on August 23, 2004.

identical circuit today in the areas that have been subject to the Commission's Phase II pricing flexibility rules would be billed \$5,900 – a price \$2,380 per month *higher*.

Like Qwest, the other BOCs have implemented increases for services in areas where they have been granted pricing flexibility. In the New York MSAs, (which purportedly includes one of the most competitive markets in the United States), Verizon has increased the prices for a similarly configured DS-1 circuit by 10%, and a DS-3 circuit by 5% since receiving pricing flexibility.³³ These price increases in Verizon's New York Phase II MSAs, as well as in Verizon's other Phase II MSAs, were implemented by Verizon in 2001 or early 2002, and thus have been sustained for close to four years.

The BOCs' Phase II price increases have been sustained for a period long enough to allow alleged competitors ample time to respond in a fashion that would constrain market pricing and force a reversal of the initial price increase. But the price increases have not been reversed because price-constraining levels of competition do not exist. Note, for example, that Verizon increased the fixed and per-mile prices for its DS-1 channel mileage services in the Phase II areas of the former Bell Atlantic region³⁴ on January 5, 2002.³⁵ According to the

³³ Verizon Telephone Companies, FCC Tariff No. 11, Access Service, Section 30.7, Effective January 5, 2002.

³⁴ Including Delaware, New Jersey, Pennsylvania, Maryland, Virginia, Washington, DC, and West Virginia. Verizon's Tariff FCC No. 1 has a single rate that applies to all of Phase II areas in all of these states.

³⁵ Verizon Telephone Companies, FCC Tariff No. 1, Access Service, Section 7, Effective January 5, 2002.

latest version of Verizon's Access Tariff, these price increases for DS-1 transport services have been "sustained" for three and a half years, from January 5, 2002 to the present. After three and a half years without entry, or a sufficient threat of entry to produce price reductions, no credible claim can be made that potential competitors exist in these seven states who have simply not had adequate time to respond to Verizon's price increase.

Similarly, Bellsouth imposed a region-wide increase in the price of a DS-1 channel termination in the Phase II MSAs in all of its nine states fifteen month ago, in March of 2004. And SBC instituted a 21% increase in the Phase II price of its DS-1 circuits in California³⁶ in May of 2003. SBC has sustained this price increase for more than two years. In fact, Ad Hoc is not aware of any circumstances in which a Phase II price increase implemented in the tariffs of the BOCs has not been sustained. There do not appear to have been any instances where the level of competition was sufficient to cause the BOC to roll back a price increase under the Commission's pricing flexibility rules.

Moreover, the Commission must recognize that, even if a BOC does not increase prices in the rate schedule for Phase II areas after establishing its initial Phase II prices, customers in the Phase II area nevertheless would experience rate increases. This is because the annual rate reductions in special access services still under price caps continued to occur through July of 2003. During that period, the BOC would increase the prices paid by customers buying special

³⁶ Pacific Bell Telephone Company, FCC Tariff No. 1, Access Service, Section 31.5, Effective May 2003.

access in an MSA subject to price caps as soon as the BOC received Phase II pricing flexibility for that MSA. Thus, the Phase II “rate schedule” may have remained unchanged, but the market price appearing on customer bills was increasing because higher pricing flexibility rates replaced the lower price caps rates. This happens each and every time that a BOC receives pricing flexibility for an additional MSA.³⁷

Table 1 below shows for each of the BOCs an example of such increases in the price for a sample 10-mile circuit (either DS-1 or DS-3) since pricing flexibility was granted. In each case, the comparison is between the prices that were in effect prior to the implementation of pricing flexibility in an MSA and the price presently in effect in the MSA. Attachment C to this pleading includes a more comprehensive comparison of selected DS-1 and DS-3 special access rates for each of the BOCs across their operating territories.

Table 1 BOC Special Access Service Prices Have Increased In Areas in Which They Have Been Granted Phase II Pricing Flexibility				
BOC	Service	Pre-Pricing Flexibility	Current Price- Pricing Flexibility	Percent Increase
Bellsouth-all states	DS-1	\$555.00	\$601.00	8%
Qwest-all states	DS-3	\$3,780.00	\$5,900.00	56%
SBC-California	DS-1	\$411.00	\$495.00	21%
Verizon- Pennsylvania	DS-1	\$679.00	\$780.00	15%

Attachment D to this pleading is a declaration filed by an AT&T witness in

³⁷ See, e.g., *Verizon Petition for Pricing Flexibility for Special Access Services*, WCB/Pricing File No. 05-11, Memorandum Opinion and Order, DA 05-1505 (rel. May 25, 2005).

the reply round of the Commission's *TRO Remand Proceeding*.³⁸ The declaration, filed in October, 2004 by Dr. Joseph M. Stith, documents the prices for sample DS1 and DS3 circuits of 0-miles and 10-miles in length, under both month-to-month and 5-year pricing terms, in each of the BOC regions during the period immediately before a grant of pricing flexibility and compares those prices to the prices in effect at the time of the filing under price caps and those under pricing flexibility. Our review of the presently effective BOC tariffs revealed that the prices documented in Dr. Stith's declaration are still in effect today, some eight months later.³⁹

In the *Notice*, the Commission referenced BOC claims⁴⁰ that increasing special access revenues are the result of increasing demand rather than increasing prices and that special access revenues per line have been decreasing.⁴¹ In the FCC's *TRO Remand Proceeding*, Dr. Taylor updated the study referenced in that declaration on behalf of Verizon,⁴² and an SBC declarant made similar claims.⁴³ As described in greater detail below, both studies were

³⁸ See note 18, *supra*.

³⁹ Review conducted June 7-9, 2005 by ETI using tariff pages accessed through the ETFS service on the FCC's web site.

⁴⁰ The claims were supported by a Kahn/Taylor declaration filed in the initial *AT&T Special Access Petition* proceeding and incorporated into the record of this proceeding pursuant to para. 5 of the *NPRM*.

⁴¹ *NPRM* at para. 76.

⁴² Comments of Verizon (filed October 19, 2004) in *TRO Remand Proceeding*, Reply Declaration of William E. Taylor Regarding Special Access Pricing on Behalf of Verizon, WC Docket 04-313, October 24, 2004 ("*Taylor Declaration*").

⁴³ Comments of SBC (filed October 19, 2004) in *TRO Remand Proceeding*, Reply Declaration of Parley C. Castro on Behalf of SBC Communications Inc., WC Docket 04-313, October 24, 2004 ("*SBC Declaration*"). In his declaration, Castro testified that SPC's DS-1

significantly flawed and neither can be used as evidence relative to pricing activity in BOC Phase II MSAs.

In his declaration, Dr. Taylor did not look at prices at all but instead used a surrogate – average revenue per voice-grade equivalent (“VGE”) channel. Changes in the average revenue per VGE can result from numerous factors – most notably changes in the mix of services actually being purchased – and such a measure is not a valid indicator of “price” whatsoever.⁴⁴ Significantly, neither SBC nor Verizon offered any direct comparison of any specific price movements over the time frames in question.

Dr. Stith’s declaration referenced above states that it was prepared as a rebuttal to these claims and did provide such specific pricing information.⁴⁵ As his declaration describes, the overall reductions to the average special access price during the time frame identified in the Taylor and SBC declarations occurred during a time frame when most special access services were still subject to price caps regulation. As detailed below, virtually all of the decrease can be attributed to the reductions required by Commission, with little to none coming from carrier-initiated reductions in Phase II areas.

Both SBC and Verizon have commingled price movements that were required under the Commission’s price caps rules with BOC-initiated price

special access rates had decreased by 11% since 2001.

⁴⁴ Interestingly, Dr. Kahn, the co-author of the original Taylor report, did not jointly sponsor this study, possibly because Dr. Kahn, in testimony presented before the US Court of Appeals, refuted the validity of exactly this type of fixed weight average as presenting misleading results. *See Association of Oil Pipe Lines v. Federal Energy Regulatory Commission and the United States of America*, 281 F.3d 239, 243; 350 U.S. App D.C. 132,136 (D.C.Cir. 2002).

⁴⁵ Stith Declaration at 3 and 4.

changes made following the onset of pricing flexibility. Table 2 below documents that, had the Commission's "GDP-PI – 6.5%" annual price adjustment rules been in effect for all special access services and for all periods since 1996, the "average" price decrease over the period would have been 28.5%, roughly double the 15.5% drop that Dr. Taylor calculated. As this table demonstrates, and assuming that the average revenue per VGE is representative of the "price" of special access, as Dr. Taylor contended it was, special access average revenues, as generated by the BOCs using pricing flexibility and other pre-pricing flexibility adjustments, were roughly 18.4% higher than they would have been had a straight application of the Commission's price cap formula been used for the full 7-year period.⁴⁶

Table 2 Comparison of GDP-PI - 6.5% Annual Price Cap Rate Adjustment with Average Revenue per Special Access VGE per ARMIS 43-03				
Year	GDP-PI	GDP-PI - 6.5%	Price Cap Index	Average Revenue per VGE Index
1996	2.0	-4.5	100.0	100.0
1997	1.9	-4.6	95.5	104.4
1998	1.5	-5.0	91.1	101.7
1999	1.1	-5.4	86.6	91.4
2000	1.6	-4.9	81.9	90.5
2001	2.2	-4.3	77.9	95.9
2002	2.4	-4.1	74.5	86.3
2003	1.4	-5.1	71.5	84.6

⁴⁶ A more comprehensive description can be found in Comments of AT&T (filed October 19, 2004) in *TRO Remand Proceeding*, Declaration of Dr. Lee L. Selwyn at 47 – 75.

2) Phase II Prices That Weren't Increased Did Not Trend Down With Costs.

Economic theory clearly suggests that competition should drive prices downward towards cost. Yet in the few instances where the BOCs have not increased prices for DS-1 or DS-3 special access circuits subject to the Commission's Phase II pricing flexibility rules, the majority of the pricing remains entirely unchanged. Yet the BOCs have realized significant productivity gains in the provisioning of special access services during this time frame. Holding prices constant in the face of substantial drops in cost structure is tantamount to a rate increase. In a well functioning and competitive market the reductions in costs would have been followed by reductions in prices. When a steady and substantial reduction in the cost of providing a service, continuing over a period of several years, is not reflected in a reduction in the prices for those services, the level of competition in the market is patently insufficient to discipline pricing. It is precisely this situation – with the BOCs increasing and/or holding constant the prices for special access services in Phase II pricing flexibility MSAs concurrent with steadily declining costs – that has allowed the BOCs to earn the staggering return levels referred to by the Commission in the *NPRM*.

Figure 3 below shows that, on a voice-grade equivalent basis, special access costs and expenses have fallen dramatically, creating a substantial gap between special access costs and rates. The rate of productivity gains clearly illustrates that the BOC's costs of provisioning special access services are plummeting, and as a result, special access customers will continue to be forced to pay price levels well in excess of anything that would be expected in a

competitive market.

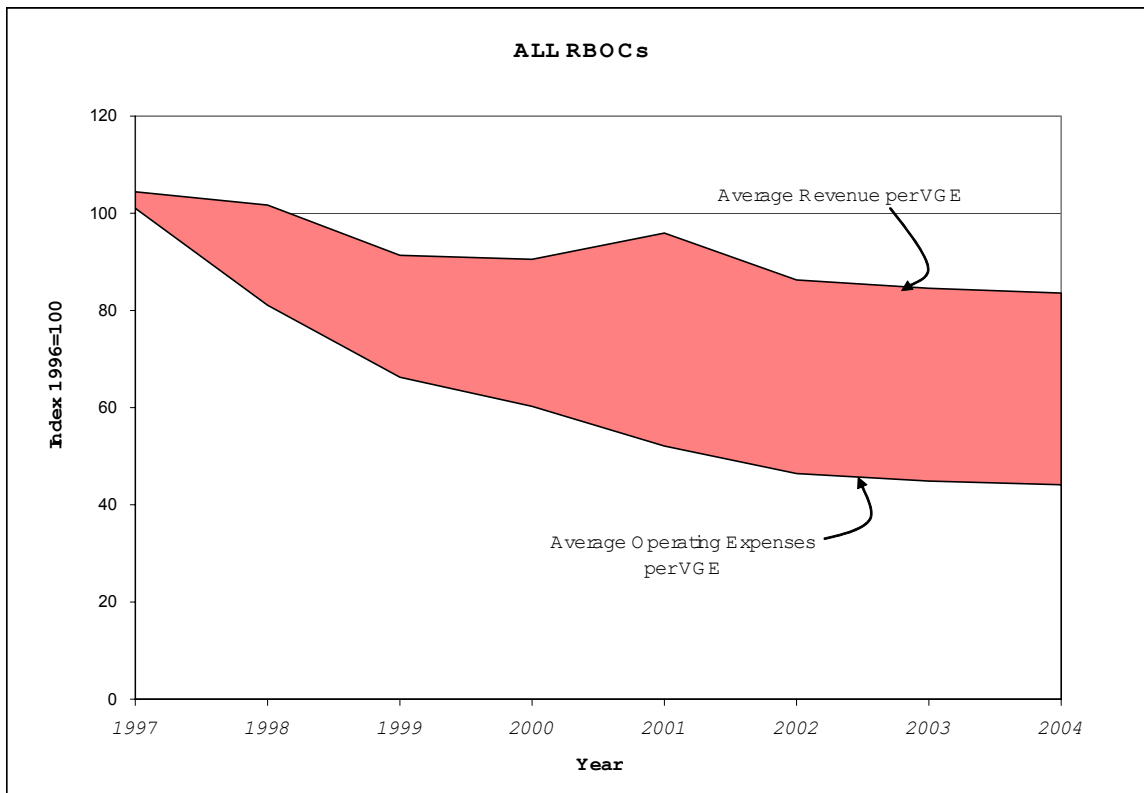


Figure 3

Given the ever increasing gap between special access costs and revenues as illustrated above in Figure 3, even the maintenance of static price levels in Phase II areas is a clear indication of market power.

3) The Appropriate Benchmark for Evaluating These Rate Increases Is A Rate of Return Benchmark

In addition to seeking information on increases in price levels since the inception of pricing flexibility, the Commission asks that parties identify, justify, and explain an objective benchmark against which to measure the most recent

rate level data.⁴⁷ The Ad Hoc Committee submits that in addition to evidence regarding the actual prices charged by the ILECs, an additional and appropriate method of measuring whether the Commission's predictive judgment was correct is an evaluation of the ILECs' earnings for the special access category. The appropriate benchmark to use for that purpose is the Commission's last-approved rate of return of 11.25%.⁴⁸ (The legitimacy for these purposes of the 11.25% rate of return level is discussed at greater length in Section II.A, below.)

The Committee does not maintain that any price that results in a rate of return in excess of 11.25% is automatically "unjust" or "unreasonable." But the steady, substantial, and sustained growth in special access earnings levels that has occurred since the pricing flexibility rules were implemented is indicative of a market in which service provider prices are not being disciplined by competitive forces. As the *ETI White Paper* pointed out, the BOCs have enjoyed steadily increasing rates of return for the Special Access service category. Returns ranged between 4.0% and 16.0% in 1996⁴⁹ The more recent data in Figure 2 reveals that the "average" BOC return on special access services has continued to grow, increasing from an average of 31.6% in 2000 to a whopping 81.9% in 2004. Returns of this level simply could not be sustained over a multi-year period in a mature market subject to competition.

⁴⁷ *NPRM* at para. 74.

⁴⁸ *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 89-624, *Order*, FCC No. 90-315, 5 FCC Rcd 7507 (1990) at para. 1, (*"Represcribing Order"*)

⁴⁹ *ETI White Paper* at note 54.

As the Ad Hoc Committee has previously pointed out, current special access rates are grossly excessive when compared to just about *any* benchmark.⁵⁰ BOCs returns are at almost unbelievable levels for special access services, with the group taken together boasting an average special access rate of return for 2004 of 53.71%.⁵¹ Individually, Verizon earns the lowest, but still substantial, rate of return of 31.64%, while Bellsouth's reported earning go well beyond substantial, with an astronomical rate of return of 81.90%.⁵² Any investor with the chance to earn an 82%, 54%, or 32% return would be foolish to pass on the opportunity.

The ILECs' primary response to evidence of the extraordinarily high level of profit on special access services has been to claim that the regulatory accounting data found in the Commission's ARMIS reports could not be credibly used for ratemaking purposes.⁵³ The ILEC criticism of earnings results based on ARMIS data must be dismissed in this instance for a number of reasons.

⁵⁰ *ETI White Paper* at 3.

⁵¹ Federal Communications Commission, ARMIS Report 43-04, Access Report, YE 2004. Available at <http://www.fcc.gov/wcb/eafs/> (accessed April 25, 2005).

⁵² *Id.*

⁵³ The ILECs' claims in this area can be found throughout the comment cycles in response to *AT&T's Special Access Petition* to re-regulate special access services (RM 10593) and in response to AT&T's Petition for Writ of Mandamus relative to that proceeding. See *AT&T Corp. Petition for Rulemaking To Reform Regulation of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services*, RM Docket No. 10593, *Opposition of Qwest Communications*, filed December 2, 2002 at pp. 8-13; *Opposition of SBC Communications*, filed December 2, 2002 at pp. 19-22; *Comments of BellSouth*, filed December 2, 2002 at pp. 4-6; *Opposition of Verizon*, at pp. 21-23. In addition BellSouth and Qwest suggested that the inclusion of DSL revenues in the Special Access Revenue category skewed results. In a declaration by Dr. Lee Selwyn, attached to AT&T's reply comments, Selwyn calculated that adjusting for DSL revenues would only reduce overall return rates by a couple of percentage points. See Reply Declaration of Lee L. Selwyn, Reply Comments of AT&T, filed January 23, 2003, at pp. 46-58, in *AT&T Special Access Petition*.

First, the ARMIS financial results simply document the costing and accounting rules that have been implemented by the Commission over several decades. The ILECs themselves have had as large or larger a role in the development of these rules as any other party. If the rules and reporting requirements do not reflect reality, now is hardly the time to complain.

Second, whether or not ARMIS data includes minor cost mis-allocations at the margins does not affect the overall integrity of *trends* in the data, since those alleged mis-allocations do not change from period to period. In other words, even if the absolute rate of return developed for the special access category using ARMIS data is off by some percentage, the trend in the data (in this case steadily *up*) is nevertheless a reliable indicator of the BOCs' ability to increase prices to supracompetitive levels without fear of attracting competitive entry.

Third, the ILECs themselves rely on ARMIS and emphasize its value and utility in other contexts. While the ILECs reject the use of ARMIS results when these reveal *excessive* earnings, they argue in favor of using ARMIS when ARMIS results suggest an earnings deficiency or "below cost" pricing.⁵⁴ The

⁵⁴ For example, in May 2003 in Federal District Court in Chicago, Illinois, just five months after having challenged the use of ARMIS data for evaluating the reasonableness of special access prices in response to the *AT&T Special Access Petition*, SBC relied specifically upon ARMIS results to support its contention that UNE rates were not covering their costs. According to SBC's expert witness:

SBC Illinois' average revenue per loop (for UNE-L) and revenue per line (for UNE-P) per month is substantially below the costs that SBC Illinois recognizes on its books to provide those UNEs. I used the FCC's financial accounting information as reported in its Automated Reporting Management Information System ("ARMIS") files to obtain the historical cost data specifically for SBC Illinois. These data are reported to the FCC for purposes of tracking the interstate rate of return and are subject to a highly detailed set of reporting guidelines.

ILECs' claims that ARMIS-based rates of return for special access are inflated by the misallocation of costs to other services (*i.e.*, the Common Line category)⁵⁵ are belied by their simultaneous defense in other proceedings and venues of the accuracy of ARMIS cost allocations to the Common Line category, thus admitting that special access costs are *not* being misallocated to that category.⁵⁶

See, Affidavit of Debra J. Aron on behalf of SBC in United States District Court for the Northern District of Illinois, Eastern Division, Case No. 03-C3290, filed May 27, 2003.

Several months later, in December 2003 SBC was joined by USTA and other BOCs in lauding ARMIS as the source for the "actual" costs of UNEs in the response to the FCC's *TELRIC NPRM*. See, *e.g.*, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, Comments of United States Telecom Association, December 16, 2003, at p. 10; Comments of the Verizon Telephone Companies, at pp. 40, 46, 58, 94; Opening Comments of SBC Communications, Exhibit A, *"The Economics of UNE Pricing,"* prepared by Debra J. Aron, PhD and William Rogerson, PhD, December 16, 2003, pp. 28-32.

One month later, in January 2004, SBC and its sister RBOCs argued to the US Court of Appeals for the District of Columbia Circuit (in opposing AT&T's Petition for Writ of Mandamus) that "ARMIS data 'contain arbitrary allocations that are 'economically irrational.'" See *AT&T Corp. et al.*, No. 03-1397 (D.C. Cir.), Response of Intervenor in Opposition to AT&T's Petition for a Writ of Mandamus, filed January 9, 2004, (*"03-1397 BOC Opposition"*) at 13.

Flip-flopping yet again only two months later, SBC defended the validity of ARMIS as the correct basis for benchmarking UNE costs in testimony filed with the Illinois Commerce Commission on March 5, 2004. SBC's witness, Dr. Aron, stated,

In the final analysis, ARMIS is no better or worse than any cost accounting system for a large, multiproduct firm. It is subject to strict reporting requirements and a consistent set of rules across carriers. Virtually all cost accounting systems will be subject to the criticism that they make allocations, and to the criticism that any full cost estimate (which, as I noted, includes TELRIC-based UNE prices as well) will reflect such allocations. However, the fact nevertheless remains that accounting systems are the basis for decision making in our economy, and that it is reasonable to look at accounting estimates of costs for benchmarking purposes such as this one.

See Illinois Commerce Commission, Docket No. 02-0864 SBC Illinois Ex. 2.2 (Sur-rebuttal Testimony of Dr. Debra J. Aron) (*"Illinois - Aron Surrebuttal Testimony"*) filed March 5, 2004, at p. 9.

⁵⁵ In its Response to AT&T's Petition for Writ of Mandamus, ILECs (including SBC) claimed that the apparently high rates of return on special access arises because ARMIS rules require that certain special access-related costs be assigned elsewhere. See *03-1397 BOC Opposition* at 14. In fact, in the interstate jurisdiction, the only other place where these costs *could be* allocated is to the Common Line category.

⁵⁶ For example, in a recent UNE proceeding, SBC submitted testimony that claimed that ARMIS costs for the switched access loop are "fairly straightforward" and reliable indicators of the investment and associated expenses specifically associated with that category (and element)." In this context, SBC's witness stated, "... the costs that ARMIS associates with the loop are fairly

In other words, to explain away excessive profit levels for special access, the ILECs assert that in ARMIS, costs associated with special access are being mis-allocated to the Common Line category. But when the shoe is on the other foot, when the ILECs are fighting arguments that ARMIS produces an inappropriately high measure of Common Line costs, they staunchly defend the use of ARMIS Common Line data as the basis for UNE-Loop prices and claim that prices based on ARMIS include only costs actually attributable to switched access loops (and certainly not costs attributable to interstate special access). At least one of these two patently conflicting claims must be false. The Commission cannot ignore ARMIS earnings data on the basis of irreconcilable and self-serving claims that ARMIS is (1) reliable for determining the cost of a single disaggregated service element but (2) unreliable for calculating the aggregate (and excessive) rate of return for the entire special access category.

In answer to the question posed by the Commission in paragraph 77 of the NPRM, the steadily escalating rates of return for the special access provide evidence that the predictive judgments upon which the Phase II pricing flexibility was granted have not been supported by marketplace developments. Using an 11.25% rate of return as a “benchmark” of reasonableness, it is clear that current BOC special access rates are excessive, and that the kinds of increases above

straightforward and, except for the shared and common costs of the sort that affect TELRIC costs as well, these costs are reliable indicators of the investment and associated expenses specifically associated with that category (and element). The shared and common costs represent a portion of the costs associated with support assets (and expenses) such as land, buildings, trucks, tools, and personnel, a share of which are appropriately assigned to elements in ARMIS. These costs are also allocated to elements in a TELRIC analysis.” *See, Illinois - Aron Surrebuttal Testimony*, at p. 9.

that benchmark that have occurred since the inception of the Commission's pricing flexibility rules are clearly so "substantial" that they put current rate levels far beyond anything that could be considered a "just and reasonable" level.

Figure 4 below demonstrates that the gap between the BOCs' special access prices and the kinds of prices that would result in a well-functioning competitive market is more "substantial" every year, and that current rates are unquestionably far above the FCC's last prescribed rate of return.

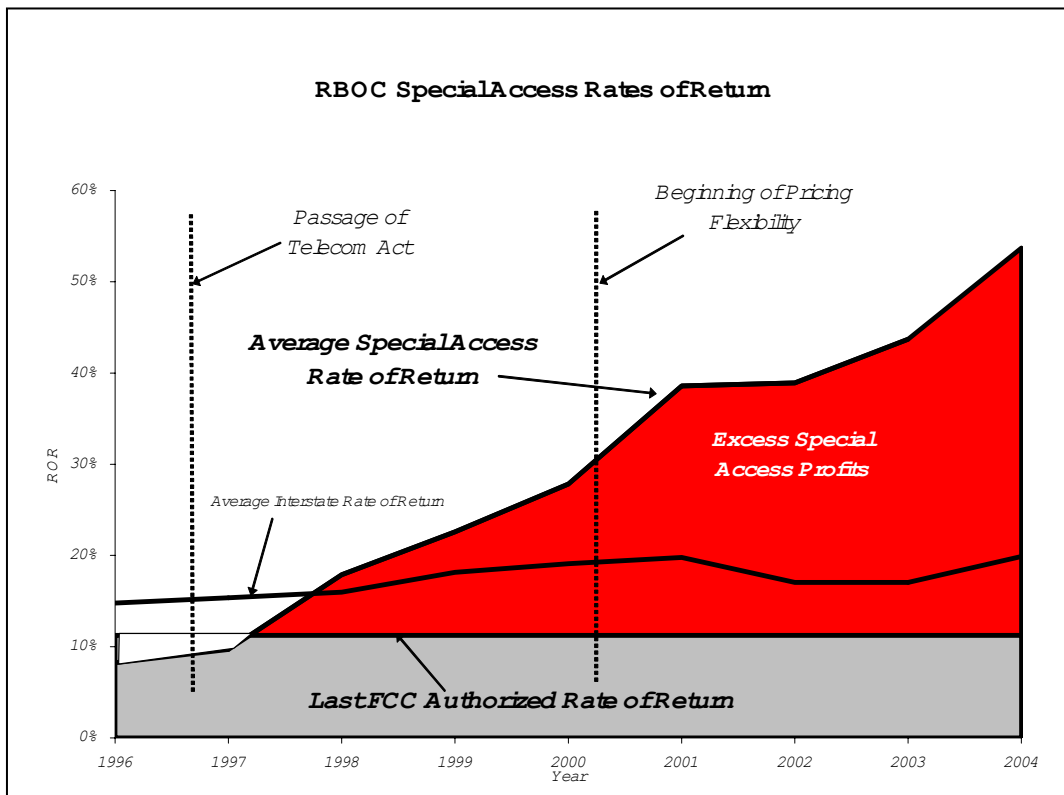


Figure 4. Average BOC special access rates of return have escalated to levels more than 4.5 times higher than the current FCC-authorized level.

4) Potential Competition Does Not Constrain The ILECs' Exercise Of Local Market Power

The Commission should reject any claims by the ILECs or their supporters that the threat of potential competitive entry is sufficient to keep the ILECs' prices

at competitive levels. This argument has been raised periodically in a variety of state and federal proceedings addressing de-regulation and/or pricing flexibility for competitive services. However compelling “potential competition” may be as a thought experiment, it has proved to be chimerical in the access marketplace. The BOCs’ substantial price increases, sustained over a multi-year period, belie any claim of a price disciplining effect from potential competition.

The general thrust of the “contestability theory” underlying potential competition arguments is that, even without competitors actively participating in the market, the threat of competitive entry alone is sufficient to discipline an otherwise monopolistic firm (*e.g.*, an ILEC with virtually 100% market share) from raising its prices to supracompetitive levels.⁵⁷ Contestability theory has been debated by economists since its original development by William Baumol in the early 1980s,⁵⁸ and it has undoubtedly broadened the possible range of regulatory responses to markets with natural monopoly characteristics.⁵⁹ Nevertheless, it has not succeeded in overturning the mainstream view that actual competitive

⁵⁷ Jean Tirole, *The Theory of Industrial Organization*. Cambridge, MA: MIT Press (1988).

⁵⁸ William J. Baumol, John C. Panzar and Robert D. Willig, *Contestable Markets and The Theory of Industry Structure*. New York: Harcourt Brace Jovanovich (1982). For an early criticism of contestability theory, see Shepard, W.G. (1984), “Contestability vs. Competition,” *American Economic Review*, 74: 572-587.

⁵⁹ See, *e.g.*, Berg, Sanford V., and Tschirhart, John, *Natural Monopoly Regulation: Principles and Practice*, Cambridge: Cambridge University Press (1988), at pp. 236-248, and James C. Bonbright, Albert L. Danielsen, and David R. Kamerschen, *Principles of Public Utility Rates*, Arlington, Virginia: Public Utilities Reports, Inc. (1988), at pp. 161-162.

entry (or in the alternative, regulatory intervention) is necessary to constrain pricing in situations where incumbents hold substantial market power.⁶⁰

The principle liability of the contestability theory for real-world application is that to be contestable, a market must allow new entrants to enter and exit costlessly, *i.e.*, without incurring start-up costs, network investments, and other capital expenditures which commit the firm to remain in the market because those costs are “sunk” and cannot be recovered if the need to exit arises.⁶¹ Economists have recognized that industries which have large capital requirements, and particularly those for which committed capital cannot be moved easily, tend to have high sunk costs and therefore are not likely to be contestable.⁶²

While ILECs tend to argue that CLECs are able to avoid significant sunk costs in local exchange markets because they can resell ILEC services and/or lease unbundled network elements (“UNEs”) instead of building facilities, successful CLEC entry in fact requires substantial financial commitments and sunk costs even when the CLEC has resale or UNE options available to it. In order to overcome the ILEC’s near-100% legacy market share and brand recognition, any entering CLEC, even those that pursue a resale-only strategy,⁶³

⁶⁰ Bonbright, et al., *id.*, at pp. 162-163.

⁶¹ Richard Schmalensee and Robert Willig, *Handbook of Industrial Organization: Volume 2*, New York: North Holland (1989), at pp. 1303-1305.

⁶² Schmalensee and Willig, *id.*, at pp. 1303-1305.

⁶³ Because resold services are priced at a fixed discount to the ILEC’s retail price level, resale-only CLECs can exert little pricing pressure on ILECs under either the traditional view or a contestable markets analysis.

must incur significant marketing, advertising, and other customer acquisition costs, many of which are not fungible. Non-resale-oriented CLECs must invest in a billing system and then either make steep investments to build their own local exchange facilities or use UNEs. But even those CLECs choosing to use UNEs incur significant nonrecurring (and sunk) costs to collocate at ILEC wire centers, and make additional investments to have ordering systems that will interface with the ILECs' operations support systems ("OSS"). In some cases, CLECs relying on UNEs also invest in their own complementary facilities, such as switches, which are also not likely to be fully recoverable if they exit the market.

Given this cost structure, it should come as no surprise that potential competitive entry has failed to exert any meaningful constraint on the ILECs' pricing for special access service. Firms in truly competitive markets would not be able to raise prices and collect supracompetitive profits as the BOCs have done for special access prices without attracting competitors who would be able to take away customers by charging fully compensatory but far lower prices. Those BOCs that increased their special access prices above the fully compensatory prices set under the FCC's price caps regime clearly were not constrained by the threat of existing or future competitors eroding the BOCs market share.

II. THE FCC MUST REINSTATE INCENTIVE REGULATION UNTIL COMPETITION DEVELOPS IN SPECIAL ACCESS MARKETS

The Commission cannot abdicate its responsibility to protect end-users from the supracompetitive prices that the ILECs have established under the

current regulatory regime for special access. The Commission must instead adapt its regulatory regime to the competitive realities of local and long distance markets and protect the interests of consumers and competition until such time as competitive providers of special access services emerge.

The Commission based its adoption of the pricing flexibility regime upon a leap of faith – a firm conviction that competition was about to flower in local access markets thanks to the market-opening requirements of the 1996 amendments to the Communications Act and the Commission's rules implementing those amendments. Instead of waiting for access markets to actually become competitive before revising its regulations, however, the Commission adopted a pricing flexibility regime that assumed competition would inevitably flourish once a competitive LEC ("CLEC") took specified steps to enter a market. Based on this "predictive judgment," the Commission's pricing flexibility rules eliminated price caps protection for customers of ILECs once an ILEC demonstrated that CLECs had taken the requisite steps to enter its market.

The Commission's predictions regarding the emergence of competition in access markets proved to be wrong, and its standards for ascertaining "irreversible market entry" by competitors proved to be misguided; the effect was to remove constraints on the ILECs' exercise of market power before competition had developed sufficiently to protect end users.

Accordingly, the Commission must replace the pricing flexibility rules with a system that can serve two objectives simultaneously. First, the Commission's rules must protect end users and competition from exploitive rates and the anti-

competitive exercise of ILECs' market power. Second, and equally important, however, the Commission's regulatory regime must accommodate changes in marketplace competition and free carriers to respond to competition (should it emerge) as quickly and efficiently as possible.

Ad Hoc's pricing flexibility proposal would serve both of these objectives. To protect customers from the ILECs' exploitive special access prices and to establish market conditions conducive to the development of competition, Ad Hoc urges the Commission to take the following steps:

- Re-initialize special access rates, including both "pricing flexibility" rates and rates in areas still subject to price caps, at levels that would produce earnings at the Commission's authorized level of 11.25%.
- Apply price caps rules to the ILECs' special access services, with an updated productivity offset and provisions for sharing ILEC earnings that exceed a specified reasonable level.
- Grant price caps ILECs unlimited downward pricing flexibility to respond to competition. Services priced using this unlimited downward pricing flexibility would be removed from price caps baskets.
- As an interim form of relief pending adoption of final rules in this docket, require ILECs in their July 1, 2005 annual access filing to restore special access prices to the levels that would be in place in accordance with the CALLS settlement had the Commission not adopted the pricing flexibility rules.

A. Re-initialize rates at levels that produce an 11.25 Rate of Return

The Commission can comfortably use the current 11.25% authorized return level as a benchmark for retargeting revenues in this proceeding. As discussed below, the 11.25% return level is likely an extremely generous mark given current market conditions and can in no way be viewed as confiscatory, or even disadvantageous, for the ILECs. Should evidence subsequently suggest it

is warranted, the FCC can revisit the 11.25% authorized return level and come up with a new, almost certainly lower, return number.

The 11.25% authorized rate of return (“RoR”) for LEC interstate access service was prescribed by the FCC in 1990 following a complete and thorough review of an extensive record.⁶⁴ The Commission followed the procedures and data requirements specified in Part 65 of its rules,⁶⁵ which establishes the methodology for prescribing an interstate rate of return. Using that methodology, the BOCs were required to provide the Commission with several different classes of evidence relating to interstate access services,⁶⁶ including: (1) the state-determined cost of capital applicable to the firm’s intrastate operations and all supporting evidence; (2) the components of Weighted Average Cost of Capital (“WACC”) calculations using two different “historic” Discounted Cash Flow (“DCF”) methodologies relying on two different costs of equity; (3) a series of cost of equity calculations using a classic DCF methodology for the RBOCs, Standard and Poors Industrials firms, and for a large group of electrical utilities; and (4) studies regarding comparable firms that demonstrate a level of risk similar to firms providing interstate access services.⁶⁷ The rules also allow additional relevant evidence to be requested by the Commission, or provided by the

⁶⁴ *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 89-624, Order, 5 FCC Rcd 7507, 7507 at para. 1. (“*Represcription Order*”)

⁶⁵ See 47 C.F.R. Part 65 (1990).

⁶⁶ *Represcription Order*, 5 FCC Rcd 7508, paras. 3-4.

⁶⁷ After extensive analysis, the Commission did not assign any weight to the studies and estimates of comparable firms. See *Represcription Order* at paras. 11 and 41.

RBOCs.

The Commission's approach to determining an appropriate RoR for interstate access services consisted primarily of an evaluation of the Cost of Capital ("CoC") components (cost of debt, cost of equity, and capital structure) separately, and then establishing a "range of reasonable estimates" of the overall CoC for interstate access services.⁶⁸ Below is a breakdown of the significant conclusions reached by the Commission in its review of the evidence presented in the proceeding:

- **Cost of Debt and Capital Structure** – The Commission found that it was appropriate to use the capital structure of the regional holding companies ("RHCs") to calculate an interstate cost of capital, which minimized the incentive for the RHCs to manipulate or alter the capital structure reported for the BOCs. The RHCs claimed that the use of the BOCs' capital structure was preferable since it would exclude debt related to non-regulated activities. However, the FCC found that by relying solely on the BOCs' capital structure, debt attributed to regulated activities and reflected in the RHCs' capital structure would be excluded. The Commission established a debt/equity ratio of 44.2%/55.8%, and an embedded cost of debt of 8.8%.⁶⁹
- **Cost of Equity** – The Commission rejected the RBOCs' contention that the use of a DCF estimate of the RHC cost of equity is not appropriate to calculate an interstate cost of capital. The Commission analyzed estimates of the RHCs' cost of equity using two historic DCF formulas,⁷⁰ as well a classic DCF formula.⁷¹ The historic DCF analyses resulted in average costs of equity of

⁶⁸ *Represcription Order* at para. 7.

⁶⁹ *Represcription Order*, 5 FCC Rcd 7510-7511, paras. 28-34.

⁷⁰ The basic DCF formula for cost of equity is as follows: Annual Dividends on a Share of Common Stock (D) / Price of a Share on a Common Stock (P) + Long Term Growth Rate of Dividends (G). The two historic DCF formulas outlined in Part 65, and analyzed by the Commission, differ in the estimate of long-term growth rate of dividends. The first formula estimates the annual rate of growth in dividends derived from quarterly dividends that were declared in the previous two calendar years. The Second formula averages the Institutional Brokers Estimate System (IBES) median long-term growth rate estimates of earnings during the two previous calendar years. *See, Represcription Order*, 5 FCC Rcd 7510-7511, paras. 36-37.

⁷¹ The Classic DCF formula for cost of equity is as follows: Expected Annual Dividends for the next year (D) / the current share price (P) + the currently-expected long-term growth rate (G),

11.7%, and 12.04%, respectively.⁷² The classic DCF analysis for the RHCs resulted in an average monthly cost of equity ranging from 11.71-12.6%.⁷³ Agreeing with the RBOCs, the Commission found that both historic DCF formulas did not reflect current market conditions and had not produced reliable results.⁷⁴ The Commission found the classic DCF formula to be more appropriate but concluded that (1) the classic DCF formula may underestimate cost of equity “due to the influence of investor expectations about cellular telephones”; and (2) the RBOC cost of equity may be higher than that for interstate access services because RBOCs operate in non-regulated businesses that carry more inherent risk. As a result, the Commission established the range of reasonable estimates of cost of equity for LEC interstate access services at 12.5-13.5%.⁷⁵

- **Cost of Capital** – The cost of debt, capital structure, and cost of equity established by the Commission (detailed above), produced a range of reasonable estimates of CoC for interstate access services of 10.85-11.4%.⁷⁶
- **Prescribed Rate of Return** – The Commission considered two additional factors: (1) infrastructure and (2) competition in the interstate access market. The Commission concluded that it should “select a rate of return in the upper part of the range of reasonable cost of capital estimates.”⁷⁷ With regard to competition in the interstate access market, the Commission concluded that the “debate in the record over the existence and significance of competition and bypass offers little guidance” on determining the range of reasonable cost of capital estimates.⁷⁸

As a result of this analysis, the Commission prescribed a RoR of 11.25%.

This RoR reflects a cost of debt of 8.8%, a debt/equity capital structure of 44.2%/55.8%, and an implied cost of equity of 13.2%.⁷⁹ At that time, the prime rate was 10% and the 10-year Treasury Bond rate was 8.89% (September, 1990).

represented by the current IBES median long-term growth estimate. *See, Represcription Order*, 5 FCC Rcd 7511, paras. 38-39.

⁷² *Represcription Order*, 5 FCC Rcd 7511, para. 37.

⁷³ *Represcription Order*, 5 FCC Rcd 7511, para. 39.

⁷⁴ *Represcription Order*, 5 FCC Rcd 7512, para. 48.

⁷⁵ *Represcription Order*, 5 FCC Rcd 7508, para. 9.

⁷⁶ *Represcription Order*, 5 FCC Rcd 7528, para. 189.

⁷⁷ *Represcribing Order*, 5 FCC Rcd 7530, para. 203.

⁷⁸ *Represcribing Order*, 5 FCC Rcd 7531, para. 212.

⁷⁹ *Represcribing Order*, 5 FCC Rcd 7532, para. 216.

Interest rates are significantly lower today – the prime rate is 5.75% and the US 10-year Treasury rate is 4.34% (April, 2005).⁸⁰ Thus, if the Commission were to actively reset its authorized return level today, it would most likely be in the 8% to 9% range.

This lower level is consistent with more recently set state-authorized RoRs. There are currently seven states in which large ILECs operate under some form of RoR regulation.⁸¹ As illustrated in the table below, the RoRs established for the ILECs by the respective state commissions in these states are all below 11.25% - ranging from 8.2% to 11.16%. Six out of the seven ILECs had their rates of return established during *or* after 1997, and three of the seven ILECs had rates of return established during or after 2001. Verizon-New Hampshire has the most recently established RoR (2004), and also the lowest RoR of 8.2%.

⁸⁰ See Federal Reserve Board, *Statistics: Releases and Historical Data*, available at <http://www.federalreserve.gov/releases/h15/data.htm> (accessed June 7, 2005).

⁸¹ See, National Regulatory Research Institute, *State Retail Rate Regulation of Local Exchange Providers as of September 2004*, prepared by Lilia Pérez-Chavolla, November 2004, available at <http://www.nrri.org>, accessed June 7, 2005.

⁸² *Investigation of the Local Exchange Revenue--Requirement, Depreciation, Cost-of-Service, and Rate Design Studies, and Tariff Rate Revisions Designated as TA429-120 and TA431-120 Filed by ACS OF ANCHORAGE, INC. et al.* Docket No. U-01-34, Order No. 15, June 6, 2002; *Application of US West Communications, Inc. For a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return Thereon and to Approve Rate Schedules Designed to Develop Such Return*, ACC Docket Nos. T-01051B-99-0105, T-01051B-00-369, Decision No. 63487, March 30, 2001; *Re: GTE Hawaiian Telephone Incorporated*, Hawaii PUC Docket Nos. 94-0298, 95-0194, Decision and Order No. 15345, January 31, 1997; *Application of US West Communications, Inc., for Authority to Increase its Rates and Charges for Regulated Title 61 Services*, Idaho PUC Case No. USW-2-96-5, Order No. 27100, August 1997; *Application of U S West Communications for Authority to Establish Rates to Recover Increased Costs Associated with 1989 Separations Changes*, Montana PSC Docket D88.12.55, Order No. 5398a, February 26, 1990; *Investigation*

Survey of State Approved Rate of Return Regimes ⁸²					
State	ILEC	Details on Rate of Return Regime	Cost of Equity	Authorized Rate of Return	Year Established
Alaska	ACS	Traditional Rate of Return	13.25%	11.16%	2002
Arizona	Qwest	Qwest: ROR with Price Caps. A rate of return is applied to the fair value of the rate base.	N/A	9.61%	2001
Hawaii	Verizon	Traditional Rate of Return	11.8%	9.73%	1997
Idaho	Qwest	Traditional Rate of Return	11.2%	9.43%	1997
Montana	Qwest	Traditional Rate of Return; Qwest can request pricing flexibility.	12%	10.44%	1990
New Hampshire	Verizon	Traditional Rate of Return	9.82%	8.2%	2004
Washington	Verizon	Traditional Rate of Return	11.25%	9.76%	1994

It is appropriate for the Commission to consider the authorized RoRs established by state commissions when determining the benchmark to use for reinitializing special access rates. In 1990, the Commission concluded “recent state decisions should be given weight as a check on the reasonableness of the current cost of equity figures reached by all the parties, and as an indicator of

into Cost of Capital, New Hampshire PUC Docket No. DT 02-110, Order No. 24,265, January 16, 2004; *Petition of GTE Northwest, Inc., for a Review of its Authorized Rate of Return*, WUTC Docket No. UT-9311591, *Third Supplemental Order*, December 21, 1994.

trends.”⁸³ In 1985, the Commission found that its “use of state authorized returns is analogous to the use of analysts’ consensus growth forecasts in the DCF model - utilizing the judgments of a group of independent experts to assist us in prescribing the interstate rate of return.”⁸⁴

B. Adopt and Apply a Revised Price Caps Regime to Protect End Users from the ILECs’ Market Power

1) X-Factor

In paragraph 35 of the *NPRM*, the Commission seeks comment on whether the present special access accounting rates of return can be used as a valid benchmark for determining the need for an X-Factor.⁸⁵ The answer is a resounding yes. In fact, in its *Price Cap Performance Review for Local Exchange Carriers* in 1995,⁸⁶ the Commission adopted an X-factor that was predicated upon the relationship of ILEC earnings to the 11.25% benchmark that has been selected here. In that proceeding, the Commission adopted an “implicit” X-factor methodology that had been developed by then Common Carrier Bureau staff members Chris Frentrup and Mark Uretsky under which the

⁸³ . The Commission found that comparing costs of equity approved by various different state commissions was more useful than comparing costs of capital, because there is no need to make adjustments for different rate base and capital methodologies. Therefore, state authorized returns on equity are provided in the table above. See *Represcription Order*, 5 FCC Rcd 7513, para. 53.

⁸⁴ *Authorized Rates of Return for the Interstate Service of AT&T Communications and Exchange Telephone Carriers*, CC Docket No. 84-800, Report and Order, Phase II, 51 Fed. Reg.1795, at para. 30.

⁸⁵ *NPRM* at para 35.

⁸⁶ *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8961 (1995) paras. 99-165.

X-factor is determined by calculating the value of the offset factor that would have been required to maintain RBOC earnings at their authorized level of 11.25%.

The *NPRM* then questions whether a new productivity based X should be developed and implemented as part of any price caps plan. The Commission should, indeed must, re-impose a productivity-based X-Factor for special access services.⁸⁷ The X-Factor can be determined through a detailed analysis of productivity growth experience coupled with an examination of input prices (also know as a total factor productivity or “TFP” study). Alternatively, an “implicit” X-Factor of the type developed by Frentrup and Uretsky and described above could also be used. In principal, both approaches should produce roughly equivalent results. Although a TFP-based X may involve more elegant economic modeling, the implicit X-Factor method can be implemented more directly and more simply than the data- and analysis-intensive TFP approach. This is particularly important in light of the limited data available in the Commission’s current reporting environment. The Commission’s elimination over the past several years of many routine data filing requirements has significantly reduced the financial data that is publicly available. Accordingly, Ad Hoc has not endeavored to quantify and submit an appropriate “X” Factor at this time, though the Committee may attempt to do so later in the proceeding as more data becomes available.

⁸⁷ *NPRM* at para 35

The final questions in the *Notice* relative to specification of an “X” revolve around whether it is necessary and appropriate to establish an “X” that is unique to the special access category. Ad Hoc submits that it is both necessary and appropriate to do so for the following reasons.

First, as discussed above (and at greater length in the *ETI White Paper* and attached Gately Declaration), the average returns for the special access category across the four RBOCs was 53.7% for 2004. The average return for interstate access services, including common, switched and special access, was almost two thirds less, at 19.9%, meaning that the average earnings on non-special access services standing alone is even lower than that.

The extreme disparity between switched and special access with respect to earnings *requires* that separate, service-specific factors be established. Special access demand has experienced unprecedented growth. As the volume of services has increased, the effects of economies of scale and scope have worked in concert to enhance productivity overall. These same factors have not been at work relative to productivity for non-special access services.

In the past when the Commission developed and used a single X-Factor for every basket of services, that single X applied across every basket. The X-Factor almost certainly was not exactly correct for every basket (perhaps it was too high for one and too low for another) but the cumulative price changes across all services were captured correctly (assuming the X-Factor was specified correctly). In the instant case, where the X is being designed to apply *only* to the special access basket, use of an X-Factor based upon firm-wide productivity

rather than an X-Factor based upon the production of special access services within the firm will necessarily result in an X that is wrong for special access. Given the prohibition on “implicit subsidies” in the Act, development and application of anything but an X unique to the special access category will result in improper implicit subsidies and illegal rates.

Fortunately, the dedicated nature of special access services and the requirements of the Commission’s accounting rules make development of a unique X for special access services quite tenable, particularly if the Commission chooses to develop that X using something akin to the Frentrup and Uretsky model used in CC Docket 94-1. Per the Commission’s rules, the investments associated with the provision of dedicated special access services are, for the most part, directly assigned to the interstate special access category. As such, using the accounting rates of return flowing out of the ARMIS system in conjunction with a target rate of return of 11.25% should result in a clean X Factor unique to the special access category.

While the RBOCs have suggested that part of the explanation for the excessively high special access earnings is the inclusion of DSL revenues in the special access revenue categories, and the exclusion of those costs from the special access investment categories, the truth of that matter has yet to be proved. Moreover, to the extent that DSL investments have not been assigned to the special access category to date, that situation should be corrected, and it should have very little impact on the overall earnings levels that have been showed to date. The incremental investment required to add DSL capability to a

standard common line borders on negligible.

2) G-Factor

Demand for special access services has resulted in growth in both the absolute quantities of special access circuits and the aggregate bandwidth of those circuits. As such it is vital that the price cap formula incorporate some measure of the impact of that growth. In fact, it is possible that the lack of a special access “G” in the plan as it existed prior to and during the CALLS regime is in part responsible for the tremendous growth in special access earnings during that time.

That being said, if the Commission utilizes an “FU”-like implicit “X” methodology based specifically upon special access category earnings in determining the X-Factor, that X-Factor should already include demand-growth related efficiencies. Absent a change in the rate of special access growth, no additional “g” factor should be required. If the Commission instead adopts a TFP-based X-Factor, a “G” factor may be more appropriate, but until such time as all of the parameters of such a study (including specification of the output units) are determined it is impossible to say if a “G” would be necessary. Therefore, the Commission should leave a holding place for a “G” factor in any plan it may devise. If and to the extent that demand for special access services begins to increase at a more rapid pace than the current trend it may be necessary, to adjust the X to account for the additional efficiencies flowing from that increased demand, and a “G” may be the easiest way to do that.

Under any circumstances, the benefits fo special access demand growth

should all flow to the purchasers of access service, whether they be end-users directly purchasing service or interconnecting carriers (IXCs, CLECs or CMRS providers) purchasing services to use as inputs to services ultimately purchased by end users. Whether the efficiencies accompanying demand growth are captured by the X-Factor methodology, or by a separate “G”, they should not be shared with the ILECs. It is corporate users, embracing technology, developing strategic applications, and constantly demanding more bandwidth that are responsible for the surge in special access demand. To the extent that the ILECs themselves have had any impact upon the demand for special access services, it has been to dampen that demand through excessive pricing of services.

3) Sharing and Low-End Adjustments

In the *1997 Price Cap Reform Order*, the Commission eliminated the sharing requirement, finding that earnings sharing blunted the incentives of price caps regulation.⁸⁸ The current NPRM contains a tentative conclusion that earnings sharing should not be a required part of any price caps plan that may be adopted for special access. Ad Hoc urges the Commission not to adopt this tentative conclusion.

First, Ad Hoc does not concur with the Commission’s earlier finding that sharing “severely blunts” the incentives to efficiency in a price caps plan.

⁸⁸ *Price Caps Performance Review for Local Exchange Carriers*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket 96-262, 12 FCC Rcd 16700, para. 148, (1997) (*1997 Price Caps Review Order*), *aff’d in part, rev’d in part, United States Telecom Ass’n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

However, even assuming it is true the Commission has a responsibility to protect ratepayers, requiring that they weigh the downside of blunting incentives for ILEC efficiency gains against the harm to ratepayers and the economy as a whole of excessive special access prices. The question also must be asked to what end are ILEC efficiency gains beneficial if those gains are not passed through as reduced prices?

If the Commission's goal in structuring a price caps plan is RBOC enrichment beyond anything that a firm operating in a competitive market would experience, then it should not include sharing in any revisions to the price caps plan. If instead the goal is to incent the RBOCs to be more efficient *so that consumers will benefit and pricing will emulate a competitive market*, then sharing is an absolute necessity.

If the specification of an "X" were an exact science, or alternately if the "X" were respecified each year (something Ad Hoc is not recommending here), sharing would be less necessary. But there is no guarantee that the "X", however it is developed, will be exactly correct, leaving purchasers of access services dependent upon mechanisms such as sharing to protect them from excessive price levels in the event the X is mis-specified.

The adage that "hindsight is 20/20" has never been more true. Review of the steadily increasing special access earnings levels over the last several years demonstrates quite clearly that the 6.5% X-Factor being applied to the special access category has not accurately reflected the productivity inherent in the production of special access services. There is no guarantee that any new "X"

included in a new plan will be entirely accurate either. The Commission must re-institute an earnings sharing component into the price caps plan.

4) Interstate Special Access Baskets and Bands

The Commission seeks comment upon the specification of baskets, bands, categories, and subcategories to be used in any new special access price caps plan. Ad Hoc is not presenting a specific basket, band, and category structure at this time. We do believe, however that a category and subcategory structure is essential to a well-functioning plan and that, at a minimum, the existing structure must be maintained. The inclusion of additional more granular categories reflecting additional, higher capacity circuits, perhaps reflecting not only different service categories as they exist today, but also the use of the facility (such that a single DS3 terminating at an end user premise might be in a different basket than a DS3 that is one of 24 terminating at carrier POP), and separating transport from channel terminations would certainly add to the effectiveness of the structure.

C. Allow Unlimited Downward Flexibility To Respond To Competition

The Commission should replace its existing pricing flexibility rules with a form of pricing flexibility that obviates the need for burdensome and time-consuming assessments of marketplace competition and instead permits the ILECs to exercise pricing flexibility wherever competition exists. Therefore, as part of a reinstituted incentive regulation plan for special access services (including services presently subject to Phase II pricing flexibility) and rate levels reinitialized to produce an 11.25% ROR, as described above, the Commission

should grant ILECs unlimited downward pricing flexibility.

By granting the ILECs' flexibility to make only downward price changes, the Commission would protect consumers from exploitive rates while granting ILECs the unfettered ability to compete effectively in areas where they deem it necessary, without the burden and delays of any marketplace assessment proceeding by the Commission. Downward-only pricing flexibility thus provides a *self-executing regulatory device* that will automatically assure the appropriate regulatory treatment of ILEC rates without the need to assess the extent to which actual and effective competition is present with respect to any particular ILEC service. ILECs would be allowed to reduce prices in response to competition but not to impose offsetting increases on other customers since there is no compelling reason why ILECs should be permitted to charge prices above the levels permitted under a price caps regime.

Unlike the Commission's existing pricing flexibility plan, Ad Hoc's downward-only pricing flexibility plan contemplates that services would always be available to subscribers at no more than the maximum price caps regulated price. Services for which the carriers choose to exercise downward only pricing flexibility would be pulled out of the relevant price caps basket for purposes of determining the actual price index ("API") and price caps index ("PCI") for the affected basket in order to prevent implicit or anti-competitive cross-subsidization between competitive and non-competitive services.

Allowing unlimited flexibility only to implement rate reductions eliminates the need for the Commission to evaluate the presence of competition or utilize

arbitrary “triggers” as a procedural short-cut in lieu of more detailed examinations of marketplace competition. Under Ad Hoc’s approach, ILECs would not be required to make a “competitive necessity” showing or provide any justification for rate reductions beyond a routine price caps filing to adjust applicable basket indices. This “self-executing” form of deregulation takes the Commission out of the debate over the actual level of competition, and offers all stakeholders – ILECs, CLECs, IXCs *and customers* – a level of regulatory certainty that exceeds anything that presently exists.

Moreover, a downward pricing flexibility plan can operate effectively whether or not actual competition exists. Ad Hoc’s plan is self-executing in that, if competition is present and robust enough to force prices lower, downward pricing flexibility will guarantee that ILECs have the independent ability and opportunity to respond to those competitive pressures rapidly and efficiently. In the absence of actual and effective competition, the price cap mechanism would operate to protect consumers from excessive or exploitive prices.

III. INTERIM RELIEF FOR JULY 1 ANNUAL ACCESS FILING

AdHoc is encouraged that the Commission seeks comment on an appropriate method of “interim relief” pending resolution of the larger issues being investigated in the Notice.⁸⁹ Purchasers of special access service have been paying inflated prices, many of them no longer protected by the Commission’s price cap rules, for far too long. Ad Hoc urges the Commission to

⁸⁹ This section of Ad Hoc’s comments responds to the questions raised in paragraphs 128 to 131 of the NPRM.

implement “Interim Relief” on July 1st or, if that is not procedurally possible, to postpone the annual access filing date for 2005 by 30 days in order to ensure that necessary procedural requirements are met.

AdHoc proposes the Commission institute an “Interim Relief” plan as specified below:

- Extend the structure of the CALLS plan as it relates to special access services for one additional year. Apply the 6.5% X-Factor to special access services effective July 1, 2005 as the same kind of “transitional mechanism to lower rates” adopted in the CALLS when it was first adopted.⁹⁰
- Amend the currently effective pricing flexibility rules so that all non-contract prices presently effective in MSA’s that have been granted pricing flexibility are set to levels no higher than the rates that would have been in effect had those prices been subject to price caps all along – including application of the 6.5% X-Factor on July 1 of this year. Note that this Interim proposal falls far short of Ad Hoc’s long-term proposal that would involve retargeting all special access prices back to a level designed to generate an 11.25% rate of return.

The CALLS Order described the 6.5% X-Factor being used for the special

⁹⁰ *Access Charge Reform*, CC Docket Nos. 96-262, 94-1, 99-249, 96-45, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962 (2000) (“*CALLS Order*”) at para. 160.

access service basket for the July 1 filings up to and through 2003 as a “transitional mechanism to lower rates” thereby avoiding issues related to the legally allowed level of a price caps “productivity factor.”

Ad Hoc suggests the use of the 6.5% Factor here, rather than the 5.3% productivity factor identified as a possible option in paragraph 131 of the *NPRM*, for two reasons. First, users of special access services have been paying grossly excessive prices for special access services for far too long – a 6.5% X Factor will offer more relief more quickly than an X of 5.3%. Second, and equally as important, the Commission notes at paragraph 131 that the 5.3% X “was adopted by the Commission and judicially upheld.” Ad Hoc is less confident than the Commission, however, that the 5.3% productivity factor would be judicially upheld again given the pendency of the remand of the 6.5% productivity factor adopted by the Commission in the *1997 Price Cap Review Order*.⁹¹ On the other hand, the 6.5% X Factor as a “transitional mechanism to lower rates” has been in effect in the Commission’s rules since June of 2000 and seems a much more logical X Factor choice.

CONCLUSION

For the foregoing reasons, the Commission should revise its regulatory flexibility and price caps rules in the manner described to ensure just and reasonable rates for end users and regulatory flexibility for ILECs to respond to competition should it emerge in the special access market.

⁹¹ *1997 Price Cap Performance Review Order*, 12 FCC Rcd at 16645, para 1.

Respectfully submitted,

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Four Attachments: White Paper FINAL 8 23 04.pdf
 COM SMG declaration.pdf
 COM SMG dft Att C.pdf
 COM Stith Declaration Reply (Final Public).pdf

Certificate of Service

I, Algerlynn Gill, hereby certify that true and correct copies of the preceding Comments of Ad Hoc Telecommunications Users Committee were served this 13th day of June, 2003 via the FCC's ECFS system.

A handwritten signature in black ink, appearing to read 'Algerlynn Gill', with a stylized, cursive script.

Algerlynn Gill
Legal Assistant

June 13, 2005